July 2022

Belleros
Capital Management

The Passionate Investor

2Q2022 Market Review and Commentary

*Market Review **

- *Equity markets generally underperformed fixed-income markets during the quarter with the S&P 500 falling 17.41% (including dividends) and the Barclay's Capital U.S. Aggregate Bond index falling 4.63%.*
- *Small caps underperformed large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned -18.02%.*
- *Value outperformed Growth during the quarter (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).*
- *International or developed, non-U.S. equity markets out-performed U.S. markets in both U.S. dollars (MSCI EAFE**: -15.15%) and local currency terms (-8.48%).*
- *The MSCI Emerging Markets Index outperformed developed, non-U.S. equity markets (international) in both U.S. dollar (-11.92%) and local currency terms (-8.45%).*
- *All U.S. market sectors were negative during the quarter. Consumer Staples (-5.01%) and Utilities (-5.25%) stocks led all other sectors during the quarter. Consumer discretionary (-27.60%), communications services (-22.31%), and technology (-21.51%) stocks were notable given their weakness.*
- *High yield bonds fell 11.80% during the quarter. The U.S. corporate bond sector decreased 6.46% during the quarter. 10-Year U.S. Treasury yields climbed from 2.36% at the beginning of the quarter to 2.98% currently (they were 1.44% at the beginning of the year).*
- *The U.S. dollar rose versus the Japanese Yen (+11.34%), the Euro (+6.36%), and the British Pound (+7.81%) during the quarter.*

** Unless otherwise noted, performances stated above reflect data provided by Standard and Poor's, Russell Investments, MSCI, and Barclay's Capital.*
*** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or international equity markets.*

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Tim Hai, CFA®, CAIA®
CIO and Sr. Portfolio Manager

Belleros Capital Management

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments."
— Seth Klarman

Company Description

Belleros Capital Management actively manages direct stock portfolios on a fully discretionary basis for institutional clients. Our primary goal is to help them outperform their benchmarks by exploiting short-term market inefficiency through a long-term investment strategy that produces investment portfolios that are differentiated in nature and is concentrated in its number of holdings. The strategy seeks to invest in the stocks of quality companies at a price that is sufficiently below our calculation of its intrinsic value. Additionally, the strategy is all capitalization in nature but tends to have a small and mid-capitalization bias that we believe is secular in nature.

Market Commentary

The S&P 500 index of large cap stocks (-17.41% in 2Q2022 and -19.96% year-to-date)[1] continued its descent last quarter as fears of inflation, rising interest rates, and a potential recession forced stock prices into bear market territory[2]. While the Russia/Ukraine conflict and China's draconian measures against COVID continued to add to the macroeconomic malaise, the U.S. Federal Reserve (the "Fed") and its efforts to stymie domestic inflation was again arguably the biggest contributor to stock price volatility during the quarter. Indeed, the Fed surprised most observers with a very rare 75 basis point ("bps") or 0.75% increase to its benchmark interest rate (it's been nearly three decades since interest rates have been increased by an amount of that size) and offered the potential for another, equally emphatic increase in the coming weeks. Stock market volatility intensified as markets priced in the increased chance that the Fed's cumulative actions would lead the economy into a recession.

S&P 500 – Trailing 1-Year, YTD, and 2Q2022 Performance

Source: FactSet

[1] Both figures are total returns.
[2] When stocks collectively fall more than 20% from their most recently reached highs.

Market Commentary…(Cont.)

Other corners of the U.S. stock market generally contracted as well. Large capitalization and value stocks spent the quarter in the red but managed to outperform small caps and growth-oriented stocks. Stocks representing every U.S. economic sector underperformed, but especially those that were technology-related or dependent on the discretionary needs of the consumer. International stocks (including emerging markets) offered good relative strength (despite rising interest rates and a strong U.S. dollar[1]) but ultimately still offered negative performance. Sharply rising interest rates meant that bonds once again failed to offer safe haven and respite from stocks with high-yielding, credit-oriented sectors faring the worst.

Recession or Not

Stocks remain(ed) volatile despite having settled questions regarding inflation and interest rates over the past year. The notion that today's inflation is not transitory, but more secular in nature has become a popular (if not settled) argument. Interest rates have been lifted and are continuing to rise at a greater pace than expected. Perhaps the last remaining question(s) include how much higher the Fed will increase interest rates and how long will this part of the cycle last. The biggest question that hasn't been answered is whether the Fed's activities will end in a recession. Many prognosticators and economists already suggest the strong likelihood of a recession (in-the-near future), with some even going as far as to say that our economy is already in one.

[1] Non-US developed and emerging market countries and companies (and their stock) typically weaken during periods of high interest rates and a strong U.S. dollar because of a poor funding environment and the higher costs necessary to service their debt.

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
— Benjamin Graham

Investment Philosophy

Market Efficiency (or Inefficiency)

Stocks are inherently volatile assets due to the sheer number of participants involved, the diversity of their motives, and the wide range of emotions they employ. Stocks are frequently prone to excessive volatility when emotions particularly run hot. We believe this excessive volatility is a sign of short-term stock market inefficiency. However, we believe the stock market is more efficient over the long-term as rational investment behavior reasserts itself. Similarly, excessive volatility causes the market prices of stocks to deviate from their intrinsic values.

As time progresses, the market prices of stocks generally return to their intrinsic values. We believe that stock market inefficiency as represented by excess volatility is exploitable and represents an opportunity for profit. In our experience, excessive volatility can and does extend to all manner of companies and stocks. Even the best companies and their stock can be affected by stock market inefficiencies and come to exhibit excess volatility, creating exploitable investment opportunity for the astute investor.

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"We steer clear of the foolhardy academic definition of risk and volatility, recognizing, instead, that volatility is a welcome creator of opportunity"
— Seth Klarman

Investment Philosophy

The Main Source of Risk to Long-term Investors

Belleros Capital Management believes that the investment community's definition of risk as volatility is inappropriate and generally does not apply to all participants. Although the effects of volatility can be particularly disastrous to investors that have near-term income or liquidity requirements, long-term investors can and should be less constrained by it. As opposed to gambling or speculation, we believe that investing is by definition a long-term strategy.

We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater risks such as a permanent loss of capital, the risk of outliving one's wealth, or the failure to meet their long-term investment and retirement goals.

Recession or Not…(Cont.)

Predictably, we don't really choose sides in the matter and are content to let time answer that question (all questions of a macro nature, really). We do not prognosticate. However, we do understand that despite rising incomes generally and high levels of savings for some, inflation is a phenomenon that afflicts everyone in varying degrees, and especially if it is more than just fleeting. If inflation is high enough, and various inflations gauges lying at 40+ year highs speak to that (Please click HERE), and is persistent, the benefit from raises and rainy-day funds may not last long enough to cushion us from recession. Understandably, the definition of what constitutes a recession or what factors are involved is more diverse than those that we've just touched upon (like the level of unemployment and corporate profits).

Mea Culpa Times Two

The recent increase in stock market volatility is not surprising. It should be expected when there is a change in focus at the Federal Reserve level. Interest rates were lowered considerably (in addition to other measures collectively known as quantitative easing) following COVID to stimulate the economy. The past year's surge in inflation has demanded a reversal of the pandemic era loosening of monetary policy. But perhaps the ride could have been a little smoother than it has been. Recall our newsletter from last year (please see below or click **HERE** to review our 2Q2021 newsletter) in which we discussed the challenges involved in making such a change. We offered that a bumpy ride should be expected even when changes are well choreographed and executed. However, we also mentioned that missteps could add considerable volatility to already volatile stocks.

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Mea Culpa Times Two…(Cont.)

"How the Fed telegraphs its motives and intent is important. It is important to understand that well-choreographed and expected changes to policy may still impact the stock market (i.e., increased volatility). However, unexpected policy changes that surprise everyone will have even stronger implications for stocks. Poor execution by the Federal Reserve has the potential to contribute significant volatility and increase stock market inefficiency. "

Over the past year, no fewer than two Fed chairpersons – current Chair Jerome Powell and former Chair and current Treasury Secretary Janet Yellen – have admitted their underestimating the duration and strength of inflation (Please click **HERE** and **HERE**). Capital markets are used to adjustments to the Fed's benchmark rate in increments of 25 bps or even 50 bps; especially if they are expected. However, a seldom-used 75 bps increase to the Fed's benchmark rate (in mid-June, 2022, please click **HERE**), on the heels of a 40-year high inflation reading in May 2022 (Please click **HERE**) suggests their surprise. An 8.74% percent drop in the S&P 500 between June 9 and June 16, 2022 show's investors surprise and disdain.

"Wide diversification is only required when investors do not understand what they are doing."
— Warren Buffett

Investment Philosophy

Diversification (or Not)

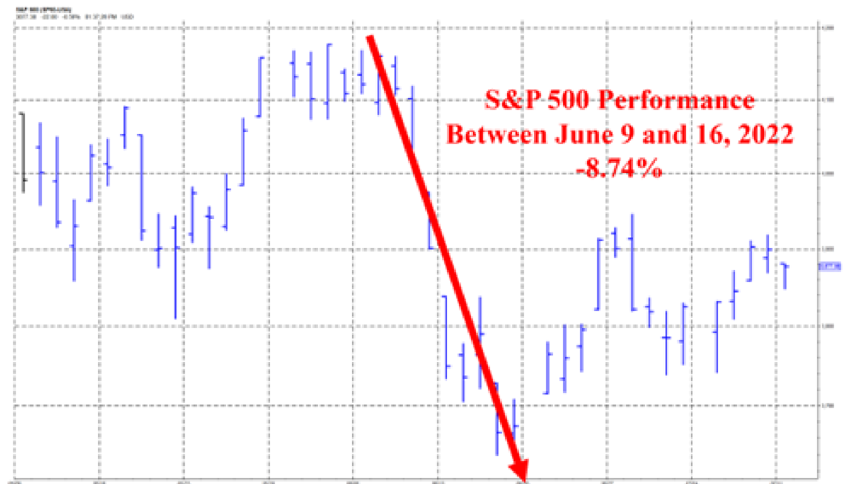
Belleros Capital Management believes the idea of portfolio diversification is counter-intuitive and works against our active management goals. The idea of diversification is meant to limit the impact of stock market volatility. We believe stock market volatility represents an investment opportunity that is exploitable. Therefore, limiting the opportunities we seek to exploit would seem rather perverse. Diversification is a sliding scale. Too little and you risk putting all your eggs in too few baskets; too much and your portfolio and expected return mimics the broader stock market (index).

We believe excessive diversification (in addition to high investment-related fees) is a main contributor to poor active management performance relative to passive/ index investing. We believe investors who seek excess returns above and beyond what one could expect to receive from the broader stock market should choose an investment manager that minimizes fees and seeks to differentiate their investment portfolio to ward off the indexing-like characteristic of diversification.

"Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments."
–– Warren Buffett

Please [contact us](#) to learn more about our investment strategy and how we try to add value for our clients.

S&P 500 – June 9 through June 16, 2022 Performance



Source: FactSet

Closing Remarks

The Fed continues to be a large contributing factor in our investment strategy. Even when they get it right, there tends to be an associated increase in stock market volatility. Volatility can become excessive when they get it wrong. As stewards of your money, we actively manage your investments and seek to take advantage of stock market volatility in the short-term – no matter the cause. We believe focus is misplaced when one worries about things that are largely beyond their control – and that's how we would classify inflation, rising interest rates, recessions, or Fed policy. Our response on your behalf is to make changes to your portfolio to take advantage of these events and not to speculate. This is how we hope to add value through our investment strategy over the long-term. And that is where we think everyone's focus should be when they are investing for the future. By understanding our role in the matter, we hope to free up your time to concentrate on simpler pleasures in life – whatever that means to you. Please enjoy the summer!

"The function of economic forecasting is to make astrology look respectable."

-- John Kenneth Galbraith

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Investment Strategy

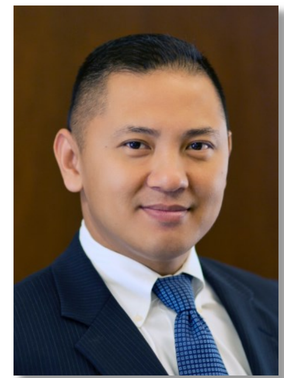
We seek to exploit stock market volatility in the short-term through a ***long-term****, active investment management strategy that seeks to purchase higher* ***quality*** *stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known as "****value*** *investing"). These characteristics help us defend against what we believe is* ***the biggest risk in investing: a permanent loss of capital.*** *In addition, we intend to show our discipline and conviction in our investments by employing a concentrated portfolio mandate that is differentiated and allows us to focus on only the best investment candidates available. Further, we seek to show our conviction through our portfolio weighting scheme which skews exposure to the best investment candidate.*

- Active investment management
- Long-term investing
- Seek higher quality opportunities
- Value investing
- Minimizing permanent losses of capital
- High conviction
- Invest with confidence
- Disciplined approach
- Volatility is an opportunity
- Concentrated stock portfolio
- Differentiated from the index

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments." — Seth Klarman

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." — Warren Buffett

Biography



Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 25 years of experience in the investment industry
- 11 years of equity portfolio management experience
- 6 years experience overseeing public equity and fixed-income assets for a $10 billion multi-employer pension plan
- 8 years exp. manager research and due diligence
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996

Tim has 25 years of diversified investment experience that includes the research and direct investment management of stocks and bonds for high net worth and small business clients. Additionally, Tim has experience in manager research and due diligence, having helped oversee and manage a $10 billion institutional pension fund. Tim had direct oversight of the pension fund's equity and fixed-income investment portfolios that were managed by outside investment managers. Tim had specific oversight over the pension fund's $1.2 billion concentrated managers program that sought to extract value add from some of the country's best investment managers through a mandate that required high conviction and a limited number of stock positions.

Tim received his B.S. in Finance from the University of Maryland, College Park and his MBA from Loyola College of Maryland. More recently, he also completed coursework in international investing and currency management with the Oxford International Investment Programme at the Said Business School at the University of Oxford, United Kingdom. Tim holds the Chartered Financial Analyst ("CFA") and Chartered Alternative Investment Analyst ("CAIA") designations. He is a member of the CFA Institute and the CFA Society Washington, DC. He is also a member of the Washington, DC Chapter of the CAIA Association.

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Disclosures

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